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The New Tax Law and Its Effects on Farmers

Almost 2 years after the Department of the Treasury released its recommendations for reforming the U.S. tax code, the President signed into law the Tax Reform Act of 1986. Most provisions take effect January 7, 1987. The reform is the most comprehensive overhaul of the Federal income tax system in over 30 years, and it has many provisions that will affect agriculture.

The act is revenue neutral—that is, it is not expected to bring in more or less tax money in total. But, it shifts the distribution of the tax burden. Over the next 5 years, individuals are expected to pay about $120 billion less in taxes, while corporations pay $120 billion more.

Like earlier reform proposals, the act provides substantial reductions in marginal tax rates and broadens the income tax base by eliminating many of the loopholes and tax shelters that have crept into the system over the years.

Greatest Impact on Overall Investment in Agriculture

The impact of the Tax Reform Act on an individual farmer will depend, among other things, on the farmer's income and investments. For most farmers, the tax burden should not change substantially. The most significant change will occur for those livestock producers with relatively high annual investment and a large proportion of their gross receipts from culled livestock. Many of these producers will face higher taxes.

For the majority of farmers, however, the most important effects of the new law are those on aggregate agricultural investment, rather than the impact on individual tax liability. The current tax system has encouraged the growth of existing farm businesses and attracted tax-motivated investments in farming. This has distorted relative input and commodity prices and has given an advantage to those able to benefit the most from the tax breaks.

Under the Tax Reform Act, reduced marginal tax rates and the elimination of some tax preference items will cause income earned within and outside of farming to be treated more equally. As a result, future decisions to invest in agriculture will be based more on economic returns and less on tax benefits.

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The most significant changes that affect agriculture include:

- reductions in individual and corporate tax rates,
- elimination of the investment tax credit,
- changes in tax depreciation rates and write-off periods,
- restrictions on deductions for the prepayment of farm expenses,
- limitations on using losses from farming to shelter other income,
- repeal of the capital gains exclusion, and
- changes in the deductibility of various development costs.

Tax Brackets Reduced to Two; Deductions Changed
The current income tax system contains 14 brackets with tax rates ranging from 11 to 50 percent. The personal exemption is $1,080 and the standard deduction is $3,670 on a joint tax return. Rate brackets, personal exemptions, and standard deductions are indexed for inflation.

Beginning in 1988, the new tax system will have only two brackets: 15 and 28 percent.[1] In 1987, there will be five tax rates: 11, 15, 28, 35, and 38.5 percent. The personal exemption will be increased to $1,900 in 1987, $1,950 in 1988, and $2,000 in 1989. The standard deduction will rise to $5,000 on a joint return in 1988. The rate brackets, personal exemptions, and standard deductions will continue to be indexed for inflation. For a family of four filing a joint return, these changes will reduce taxable income by about $5,000 per year.

To broaden the tax base, some deductions will be eliminated. The main nonbusiness deductions repealed include the two-earner deduction for married couples and the itemized deduction for State and local sales taxes. Income averaging will also be repealed. Deductions for contributions to individual retirement accounts will be eliminated for joint filers covered by business pension plans and having adjusted gross income over $50,000.

Now, more than half of all farmers are in tax brackets over 15 percent. Under the new act, between 75 and 80 percent of all farmers will be in the new 15-percent bracket.

Federal income taxes paid by individuals on their farm and nonfarm income will be about the same or less than under current law. The higher personal exemptions and standard deductions and lower tax rates should offset losing some deductions and credits. In fact, raising the personal exemption to $2,000 and the standard deduction to $5,000 will reduce the taxable income of individuals with farm profit or loss by about $10 billion annually. Self-employment (Social Security) taxes for most farmers should also decline slightly.

Corporate Tax Rates Lower
Under current law, corporate tax rates are graduated, with a top rate of 46 percent. Under the Tax Reform Act, the top rate will be reduced to 34 percent. The graduated structure will be retained for corporations with taxable income of $335,000 or less.

[1]Phase-out of the benefits of the 15-percent bracket and the personal exemption amount beginning at $71,900 for joint returns will result in an effective marginal rate of 33 percent for these high-income taxpayers.

Between 1974 and 1982, the number of corporate farms increased from about 28,000 to almost 60,000. This growth came almost entirely from an increase in family and other closely held farming corporations. Much of the growth can be attributed to Federal tax policies that favor corporations. While most small family farm corporations will continue to benefit from the graduated tax rate structure under the new law, sharp cuts in individual tax rates will reduce the incentive to incorporate.

Depreciation and Investment Tax Credit Changed
The Accelerated Cost Recovery System (ACRS) enacted in 1981 allows depreciable assets to be written off at accelerated rates over periods of 3 to 19 years, depending upon the type of asset. Most farm assets are written off over 5 years. Depreciation deductions are based on the historical cost of assets and thus are not indexed for inflation. Each taxpayer can immediately deduct up to $5,000 of investment each year.

Most depreciable farm property also qualifies under current law for the 6- or 10-percent investment tax credit. Qualifying farm property includes machinery; equipment; livestock purchased for dairy, draft, breeding, or sporting purposes; crop storage facilities; and single-purpose agricultural structures. For farmers and others who plant trees for timber, up to $10,000 a year of reforestation expenditures are eligible for the investment tax credit. These expenditures can also be amortized over 7 years.

Under current law, if the full tax credit is claimed, the basis for depreciation (cost of the asset) is reduced by 50 percent of the investment tax credit. Alternatively, the taxpayer may reduce the original 6- or 10-percent credit by 2 percentage points. For example, the purchaser of a farm tractor may claim the full 10-percent tax credit and depreciate only 95 percent of the tractor's cost, or take an 8-percent tax credit and depreciate its full cost.

Under the new tax law, the ACRS will be retained with modifications (see table). The option to immediately deduct up to $5,000 of investment will be increased to $10,000 for businesses which invest less than $200,000 per year. Depreciation deductions will not be adjusted for inflation.

New Accelerated Cost Recovery System

Asset category	Tax life	Depreciation rate*
Horses & breeding hogs	3	200%
Sheep and goats, autos & light trucks, breeding & dairy cattle	5	200%
Most other depreciable farm machinery & equipment, including crop storage & single-purpose agricultural structures	7	200%
Orchards & vineyards	15	150%
General-purpose farm structures	20	150%

*Declining-balance method at rate specified. For example, depreciation deductions for a dairy cow would be determined by reducing the cost by previously deducted depreciation, if any, and multiplying that balance by 40 percent (twice the 20-percent straight-line rate).

The Tax Reform Act repeals the investment tax credit effective January 1, 1986. But, credits acquired in the past may still be used, in gradually declining percentages. In 1987, 82.5 percent of unused credits may be carried forward; in 1988 and after, 65 percent may be used. The 10-percent credit for reforestation expenditures is retained. Farmers earning 50 percent or more of their gross income from farming are allowed to carry existing investment tax credits back 15 years in recalculating past taxes owed. However, the refund under this carryback provision is limited to the lower of: (1) 50 percent of the amount carried over, (2) the taxpayer's net tax liability for the past 15 years, or (3) $750.

Under the new law, depreciation rates will be accelerated but recovery periods will be lengthened. This, in combination with the loss of the investment tax credit, will raise the cost of farm capital about 10 percent. This increase should result in slightly lower investment in agriculture. In addition, the new law's failure to adjust depreciation deductions for inflation will result in continued fluctuations in incentives to invest.

Over One-Third of Farm Investments Will Be Deductible as Current Expenses

The new law's option to deduct up to $10,000 per year as a current expense will allow over one-third of all farm investment to be currently deducted. Ninety percent of all farmers will simply deduct their total investment for the year and will not be burdened with the complexities of calculating depreciation. The increase in the cost of capital will be only about 6 percent for these farmers.

Farmers currently claim in excess of $1 billion in tax credits per year. However, a large share of this is claimed by individuals with high incomes to shelter. Farmers with gross receipts between $50,000 and $500,000 are able to claim only about half of the investment tax credit available to them because many of them owe no taxes.

Farm sole proprietorships held over $3 billion in accumulated tax credits in 1983. While more recent information is not available, it is likely that current accumulated tax credits equal or exceed this level. A large share of these unused credits is held by farmers with substantial debt and little or no off-farm income. Thus, these farmers will be the primary beneficiaries of the provision that allows taxpayers to get a refund on taxes already paid by carrying back existing tax credits. These farmers will also suffer the largest share of the loss due to the gradual reduction in the percentage of tax credit that can be carried over to future years. This reduction could cost farmers about $1 billion in unused tax credits.

Special Capital Gains Treatment Ended

When property used for business or held as an investment is sold, generally any profits qualify for capital gains treatment. Under current law, only 40 percent of long-term capital gains must be included in taxable income. With the top tax rate at 50 percent, the maximum tax on long-term capital gains is 20 percent (40 percent taxable times 50-percent tax rate). Farm assets eligible for the exclusion include dairy and breeding livestock and farmland.

Under the new law, capital gains treatment will be eliminated; these gains will be taxed as ordinary income. Thus, for an investor in the top 28-percent tax bracket, the maximum tax rate on long-term capital gains will increase from 20 to 28 percent. Most farmers will be in the new 15-percent bracket and will therefore pay 15 percent on capital gains. Many of these farmers currently pay a tax of less than 10 percent on long-term capital gains.

For dairy farmers who have contracted to sell their cattle under the Dairy Termination Program, the new act provides a transition from the old capital gains treatment to the new. Gains from dairy cattle sold under the program will continue to qualify for special capital gains treatment through September 1, 1987.

The Tax Reform Act also provides that any profit from selling converted wetland or highly erodible cropland used for farming after March 1, 1986, be taxed as ordinary income, not capital gains. In addition, any loss is treated as a long-term capital loss.

Cash Accounting Can No Longer Be Used To Defer Taxes

Since 1915, farmers have been allowed to use the cash method of accounting for Federal income taxes, on the grounds that the more complicated accrual accounting would be a burden. On 1982 Federal income tax returns, about 98 percent of farm sole proprietorships used the cash method, as well as many farm corporations and partnerships.

Under cash accounting, expenses are deducted in the year they are paid, income is recognized in the year it is received, and changes in the value of inventories are ignored. This greatly simplifies recordkeeping. However, it permits investors to mismatch income and expenses by taking deductions in the early years of an investment, while postponing taxes on income by building inventories that are not taxed until they are sold.

Because some tax-shelter investors have abused cash accounting, Congress earlier attempted to limit its application. Under current law, some nonfamily corporations with gross receipts over $1 million are prohibited from using cash accounting. In addition, farm syndicates and cash basis tax shelters are required to claim tax deductions for feed, seed, fertilizer, and similar inputs in the years they are used, regardless of when they were purchased.

The Tax Reform Act retains cash accounting with some further conditions. Farmers who use it will not be able to deduct prepaid amounts for feed, seed, fertilizer, or similar supplies beyond half of total farm expenses (excluding the prepaid farm supplies) until the inputs are actually used. A similar rule will apply to certain poultry costs. However, a taxpayer who lives on the farm and whose principal occupation is farming will not be subject to the new limitation if (1) the prepayment limitation has been met for the 3 preceding tax years, or (2) the excess prepayment is due to a business operations change caused by extraordinary circumstances.

In effect, by retaining the right to use cash accounting but limiting prepayment deductions, the new law will allow farmers to continue using cash accounting because of its convenience, but will restrict the abuse of the system to defer taxes. Providing exceptions for some farmers will ensure that the limitation will affect only the true abusers of the ability to deduct prepayments.

Land-Clearing No Longer Deductible As Current Expense

Under current law, farmers are permitted to claim immediate tax deductions for expenditures on soil and water

Comparison of Current and New Tax Law

Tax provision	Current law	Tax Reform Act
Standard deduction (joint return)	$3,670	$5,000 1/
Personal exemption	$1,080	$2,000 2/
Individual tax rate schedule (joint return)	14 brackets 11% bottom rate 14% over $4,530 25% over $22,880 33% over $34,310 50% over $171,580	2 brackets 3/ 15% bottom rate 28% over $29,750
Corporate tax rate schedule	5 brackets 15% bottom rate 18% over $25,000 30% over $50,000 40% over $75,000 46% over $100,000	3 brackets 15% bottom rate 25% over $50,000 34% over $75,000
Income averaging	Allowed if income is $3,000 more than 140% of prior 3-year average income.	Repealed.
Investment tax credit	Rate of 6% or 10% for most types of depreciable farm capital.	Repealed. Carryover of 65% of unused credits, and 15-year carryback for farmers resulting in refund of up to $750 of unused credits.
Tax depreciation	Most farm assets —5 years, 150% declining balance method. No indexing.	Auto, light trucks and most livestock —5 years. Most farm equipment —7 years, 200% declining balance method. No indexing.
Expensing (annual limit)	Up to $5,000, increasing to $10,000 in 1990.	Up to $10,000.
Capital gains	Exclusion —60%. Top tax rate —20%.	Repeal of exclusion. Top tax rate —28%.
	Breeding and dairy livestock qualify for the exclusion.	All gains are taxed as ordinary income.
Deductions for passive losses	Passive losses can be used to offset other income, and can be carried forward.	Passive losses cannot offset other income but can still be carried forward.
Cash accounting	Most farms eligible. Farm corporations with sales over $1 million must use accrual accounting.	Same as old law, but new limits on deductibility of prepaid expenditures.
Development expenditures	Immediate deductions for cost of raising dairy and breeding cows and developing new orchards and vineyards.	Capitalization of expenditures for plants or animals with preproductive period of more than 2 years. Option to avoid capitalization by using straight-line depreciation.
Soil and water conservation, land clearing costs	Immediate deduction of S&W conservation and land clearing expenditures.	Repealed except for S&W plans approved by USDA or comparable authority.
Fertilizer, lime, & other soil conditioners	Immediate tax deductions for all expenditures.	No change from current tax law.
Health insurance costs	Not deductible by the self-employed.	25% of health insurance costs deductible. 4/.

1/ Effective Jan. 1, 1988; $3,760 for 1987. 2/ Effective Jan. 1, 1989; $1,900 for 1987 and $1,950 for 1988. 3/ Rates for 1987 would be 11, 15, 28, 35, and 38.5 percent. 4/ Deduction applies only to tax years after 1986 and before 1990.

conservation, land clearing, and fertilizer, lime, and other materials used to enrich or condition the soil. The soil and water conservation deduction is limited to 25 percent of the taxpayer's gross income from farming. The land-clearing deduction cannot exceed $5,000 or 25 percent of net taxable income from farming, whichever is smaller. Sole proprietors now claim about $200 million for soil and water conservation and land-clearing expenditures each year.

The Tax Reform Act no longer allows land-clearing expenditures to be currently deducted. The expenditures must be added to the basis of the land and recovered only when the land is sold. However, routine brush clearing and similar activities on land already cultivated will continue to be currently deductible as ordinary business expenses. Repealing the special provision for land clearing is designed to reduce the current incentive to bring additional, sometimes marginal land into production.

Fertilizer and soil conditioning expenditures will still be currently deductible. Soil and water conservation expenditures also will continue to be currently deductible if they are consistent with a conservation plan approved by the USDA Soil Conservation Service or a comparable State agency. But, expenditures for general earth moving, draining, or filling of wetlands, or the costs of preparing land for installation or use of a center pivot irrigation system, will no longer be currently deductible as soil and water conservation costs.

Development Expenditures Restricted

Under current law, farmers may claim immediate tax deductions for the development of certain capital assets. For example, the cost of raising dairy, draft, breeding, and sporting livestock to maturity and the costs of caring for new orchards and vineyards until they reach bearing age may be deducted in the tax year in which such expenses are paid. Most costs of producing timber, except for planting costs and cultural practices before the seedlings are established, are also currently deductible.

This immediate deduction of development costs distorts the expenses and income from the developed asset. This mismatching has been used to generate immediate losses that can then be written off against income from other sources. Farm assets, among others, have been used to create such tax shelters.

Concern about how investments in such shelters were affecting farm production and prices prompted Congress in the past to place restrictions on the deductibility of some development expenses. Thus, citrus and almond grove developers, farm syndicates, and some farm corporations are required to capitalize (add to the cost or basis of the asset) some preproduction costs. However, a special rule allows growers to immediately deduct the cost of replacing plants lost because of freezing, disease, drought, pests, or other casualty, if the grower replants the same type of plants on the same property.

Under the Tax Reform Act, preproductive expenditures for animals and plants (except timber) with a development period of 2 years or longer must be capitalized and either claimed later as depreciation deductions or subtracted at the time of sale from the asset price to compute the taxable gain. However, the existing exception for destroyed plants will be expanded. Under the new law, plants may be replanted on any parcel of similar-size land in the United States, by the person who owned the affected grove, orchard, or vineyard at the time of the loss or by a person who acquires a minority interest and materially participates in the operation of the enterprise. The exception applies only to crops produced for human consumption, though.

Under the new law, the after-tax costs of developing groves, orchards, and vineyards and raising most cattle will increase. New investments in these areas thus will be based more on prospective returns and less on tax benefits. As a consequence, tax-shelter investments in the orchard and livestock sectors will be reduced.

The requirement to capitalize development expenditures could impose a significant recordkeeping burden on many farmers. However, under the new law farmers may still elect to currently deduct development expenditures, as long as they use straight-line depreciation for all farm assets placed in service during the year the development deduction is taken.

Losses From "Passive Activity" No Longer Applicable to Other Income

Under current law, with few exceptions, losses and credits generated from one activity can be used to offset income or tax from other sources. But the Tax Reform Act limits the ability to shelter other income this way to those taxpayers who "materially participate" in the activity generating the losses or credits. To satisfy the material participation requirement, the taxpayer must be involved in the activity on a "regular, continuous, and substantial basis."

The new law allows up to $25,000 of losses from rental real estate, including farmland, to be used to shelter other income, provided that the taxpayer participates significantly in management decisions. This $25,000 exception is phased out for taxpayers with adjusted gross income in excess of $100,000, however. As under current law, losses or credits may be carried forward and used to offset future income from the same activity, regardless of whether the taxpayer materially participates. The new rules will be phased in over 5 years.

The new law retains many preferential tax provisions for farmers. Active farmers will be able to continue using farm losses to offset other income. But, the new passive loss rules will severely limit the opportunities of nonfarmers (passive investors) to exploit farm losses to shelter nonfarm income.

In 1982, $18 billion in farming losses was used to offset other income, resulting in about $5.3 billion in tax savings. Only a small percentage of these losses will be affected by this new limit. However, those areas of agriculture where passive investments are important—such as cattle feeding—could lose investors over the 5-year phase-in period.

For the Self-Employed, Health Insurance Now Partially Deductible

Under current law, an employer's contribution to a health insurance plan is not considered income to the employee. However, self-employed individuals, including farm sole proprietors and partnerships, may not deduct the health insurance premiums they pay.

The Tax Reform Act provides the self-employed individual a new deduction—25 percent of the cost of providing health

insurance for the individual, spouse, and dependents. The deduction is limited to the taxpayer's earned income for the taxable year. In addition, no deduction is allowable for any tax year in which the self-employed individual or spouse is eligible to participate in a subsidized health plan offered by an outside employer. The health insurance deduction is available only for tax years beginning after December 31, 1986, and before December 31, 1989.

Permitting self-employed individuals to deduct a portion of their health insurance costs will temporarily reduce the current advantage held by employees of corporations. However, restricting the deduction to 25 percent and limiting the period of availability greatly reduce the significance of this change.

New Law Expands Use of Tax-Exempt Bonds for First-Time Farmer

Interest on bonds issued by State and local governments is generally exempt from Federal income taxes. These tax-exempt bonds include industrial development bonds (IDB's, also called "aggie bonds") used by many States to provide low-interest farm loans. A special rule under current tax law allows small tax-free bonds to be issued to help first-time farmers finance farmland and a minimal amount of used equipment, to enter farming.

The Tax Reform Act retains through 1989 the exemption for interest from small-issue IDB's used for agricultural purposes. The tax-free bonds for first-time farmers will be expanded to include farmers who would have qualified under current law except that they once owned land and then lost it through an insolvency proceeding. In addition, the amount of used equipment that may be financed will be increased to 25 percent of funds provided, and the equipment purchase need not be in conjunction with a land purchase. The new law will also impose a $250,000 lifetime limit on the amount of depreciable farm property one person can finance through the tax-free bonds.

The use of tax-exempt bonds to finance State agricultural credit programs has grown considerably in recent years. Retaining the tax exemption for holders of these bonds retains a low-cost source of funds for these programs. The new law will expand the number of individuals eligible for assistance under the first-time farmer exception and therefore could expand the scope of these programs at least through 1989.

Law Affects Various Operations Differently

How will the new tax law affect specific types of farm operations? Because of differences among farms and the wide range of tax changes, the effects vary significantly. Following are discussions of effects on selected types of farms.

Effects on Orchard Development.—Orchard investors have several years of costs before their trees bear fruit. Under current law, land and planting costs are capitalized. But cultural costs are tax deductible in the years they are paid. (Citrus and almond orchards are an exception; their cultural costs for establishment must be capitalized.)

Consider under current law an orchard investor in the 50-percent income tax bracket who has tax-deductible cultural costs of $500 per acre per year. Deduction of the costs cuts his or her taxes by $250 per acre per year. When

Federal Taxes for Orchard Development, Current and New Law

Item	Year 1	2	3	4	5
			$/acre		
Land costs	2,000				
Planting costs	1,500				
Cultural costs	500	500	500	500	500
Selling price					8,000

Item	Current law	New law
	$/acre	
Deductible cultural costs	2,500	0
Tax rate	.50	.28
Tax savings	1,250	0
Selling price	8,000	8,000
Basis	3,500	6,000
Capital gain	4,500	2,000
Percent taxable	.40	1.00
Taxable gain	1,800	2,000
Tax rate	.50	.28
Capital gains tax	900	560
Capital gains tax	900	560
Tax saving (cultural costs)	-1,250	-0
Net tax	-350	560
Gross profit	2,000	2,000
Income tax	+350	-560
After-tax profit	2,350	1,440

the orchard is sold, the investor's taxable profit is the $8,000-per-acre selling price minus the $3,500 basis (land and planting cost), or $4,500.

Since only 40 percent of this is taxable (capital gains rate), the capital gains tax is only $900 ($4,500 x .40 x .50), and the investor saves $1,250 over 5 years from the tax deductions for the cultural costs. Therefore, the orchard investment actually reduces his/her taxes by $350 per acre. The after-tax profit is $8,000 minus $6,000 (land, planting, and cultural costs) plus $350 (tax savings)—or, $2,350 per acre. Thus, profit is greater than if the entire investment were exempt from taxation.

Under the Tax Reform Act, the costs for developing orchards will no longer be currently deductible.[2] Instead, these costs will be capitalized by all orchard developers—not just citrus and almond growers. In addition, all long-term capital gains will be taxable, rather than the 40 percent under current law. However, tax rates will be reduced, with the top tax rate falling from 50 to 28 percent.

Assume the same orchard investor is in the top 28-percent bracket under the new law. Since he or she is not able to deduct the cultural costs, the total cost of establishing the orchard is $6,000 per acre (land, planting, and cultural costs). The gain is $2,000 per acre and the tax is $560 (.28

[2]The taxpayer may elect to deduct costs currently. However, if this election is made straight-line depreciation must be used on all farm property.

x $2,000). Under the new law, the after-tax profit is $1,440—less than the before-tax profit.

Effects on a Crop Farm.—This example represents a 252-acre corn farm. The proprietor's spouse earns $18,597 in an off-farm job and the couple has two children for a total of four exemptions. They claim the standard deduction.

Under current law, the farmer has a net farm profit of $3,825 (Schedule F), and $600 in capital gains from breeding-cattle sales (Form 4797). The family pays $2,225 in income taxes, and an additional $470 in self-employment taxes, for a total tax obligation of $2,695.

Under the Tax Reform Act, the favorable capital gains treatment for breeding livestock sales is eliminated, and $600 of these sales are now taxed as ordinary income. The producer's depreciation deductions rise by $4,288 because of the increase from $5,000 to $10,000 in the amount that he can treat as ordinary expense and the acceleration of depreciation deductions. However, the family loses the investment tax credit and the two-earner deduction.

Nevertheless, under the new law, the corn producer's Federal income taxes decline by $639. In addition, he pays no self-employment tax. The net result is a $1,109 decline in his and his spouse's total Federal tax liability, from $2,695 to $1,586.

1987 Federal Taxes for a Crop Farm, Current and New Law

	Current law	New law
Schedule F		
Gross farm receipts		
Field crop sales	$56,740	$56,740
Cattle sales	4,400	4,400
Gross receipts	$61,140	$61,140
Farm deductions		
Production costs	47,565	47,565
Depreciation	4,750	4,038
Expensing of capital	5,000	10,000
Total deductions	$57,315	$61,603
Net farm profit (loss)	$ 3,825	$ (463)
Form 4797		
Breeding cattle sales	600	600
Exclusion (60%)	360	—
Taxable gain	$ 240	$ 600
Form 1040		
Wages	18,597	18,597
Interest income	4,000	4,000
Capital gains	240	0
Other farm income	0	600
Net farm profit (loss)	3,825	(463)
Total income	$26,662	$22,734
Spousal deduction	383	0
Adjusted gross income	26,279	22,734
Personal exemptions	-4,440	-7,600
Taxable income	$21,839	$15,134
Income tax	2,670	1,586
Investment tax credit	445	—
Net income tax	$ 2,225	$ 1,586
Schedule SE		
Self-employment income	3,825	(463)
Self-employment tax	470	—
Total Federal taxes	$ 2,695	$ 1,586

1987 Federal Taxes for a Dairy Farm, Current and New Law

	Current law	New law
Schedule F		
Gross farm receipts		
Milk	$144,880	$144,880
Dairy cow sales	—	—
Gross receipts	$144,880	$144,880
Farm deductions		
Production costs	98,980	94,980 1/
Depreciation	10,915	10,833
Expensing of capital	5,000	10,000
Total deductions	$114,895	$115,813
Net farm profit	$ 29,985	$ 29,067
Form 4797		
Dairy cow sales	8,604 2/	8,604 2/
Exclusion (60%)	4,864	—
Taxable gain	$ 3,740	$ 8,604
Form 1040		
Nonfarm income	8,205 3/	9,117
Capital gains	3,243	—
Other farm income	497	8,604
Net farm profit	29,985	29,067
Total income	$ 41,930	$ 46,788
Adjusted gross income	41,930	46,788
Personal exemptions	4,440	7,600
Taxable income	$ 37,490	$ 39,188
Income tax	6,534 4/	6,160 4/
Investment tax credit	1,003	—
Net income tax	$ 5,531	$ 6,160
Schedule SE:		
Self-employment income	$ 29,985	$ 29,067
Self-employment tax	3,688	3,575
Total Federal taxes	$ 9,219	$ 9,735

1/ Feed costs for heifers to be capitalized and added to depreciation deductions beginning with the 1989 tax year. 2/ Sales net of basis. 3/ For current law, nonfarm income reported net of spousal deduction of $912. No spousal deduction permitted under tax reform. 4/ Assumes use of the standard deduction.

Effects on a Dairy Operation.—This example represents an 80-cow herd. This farm produces most of its forage but purchases feed concentrates. The operator and one hired worker provide labor. The farmer's spouse also earns some off-farm income. Investment is distributed evenly over time and consists of equipment, machinery, dairy barns, and multipurpose structures. The farmer replaces 24 cows every year; 20 are raised on the farm while 4 are purchased.

The most significant tax changes for this farmer will come from the elimination of the investment tax credit and capital gains treatment for dairy cows. Overall, tax reform will increase this farmer's tax liability.

Under current law, the farmer earns $29,985 in net farm profits (Schedule F), and $3,740 in taxable gains from dairy

Rules Change for Discharge-of-Indebtedness Income

Under current law, forgiven debts are considered taxable income to the debtor. Thus, a farmer who turns over farm property in satisfaction of debt or who participates in a debt write-down program may have to pay more taxes than he would otherwise.

Under the current law, three types of exclusions permit the taxpayer to avoid considering discharge of indebtedness as income: actual declared bankruptcy, insolvency, and qualified business indebtedness. These exclusions still require the taxpayer to charge the forgiven debt as income to reduce various tax attributes he may have acquired (e.g., net operating losses or investment tax credit carryovers) which could provide future tax benefits. The exclusion for qualified business indebtedness is limited to the amount of the taxpayer's basis in depreciable business assets.

The exclusions provided under current law are frequently inadequate to facilitate restructuring or renegotiation of agricultural loans. The exclusion for insolvency provides no protection to farmers whose assets exceed their debts but who have insufficient cash to pay off their debts. In addition, the exclusion for qualified business indebtedness may be of limited use to farmers, since debts for farmland do not qualify for the exclusion.

The Tax Reform Act provides a new exclusion for the farm debt of a taxpayer who received more than half of gross receipts for the preceding 3 taxable years from farming. The new exclusion treats discharge-of-indebtedness income as if it were realized by an insolvent taxpayer. Thus, discharge-of-indebtedness income will be forgiven—not considered taxable—after reduction of tax credits, net operating loss carryovers, and basis in any remaining farm assets, including farmland. This treatment applies to discharges after April 9, 1986.

1987 Federal Taxes for a Hog Operation, Current and New Law

	Current law	New law
Schedule F		
Gross farm receipts		
Swine receipts	$182,789	182,789
Soybean sales	24,785	24,785
Corn sales	36,025	36,025
Sow sales	—	—
Gross receipts	$243,599	$243,599
Farm deductions		
Production costs	175,202	175,202
Depreciation	24,738	23,885
Expensing of capital	5,000	10,000
Total deductions	$204,940	$209,087
Net farm profit	$ 38,659	$ 34,512
Form 4797		
Sow sales	9,508	9,508
Exclusion (60%)	5,704	—
Taxable gain	3,804	9,508
Form 1040		
Interest and other income	2,693	2,693
Capital gains	3,804	—
Other farm income		9,508
Health insurance deduction	—	- 400
Net farm profit	38,659	34,512
Total income	$ 45,156	$ 46,313
Adjusted gross income	45,156	46,313
Personal exemptions	4,440	7,600
Taxable income	$ 40,716	$ 38,713
Income tax	7,528	6,027
Investment tax credit	2,320	—
Net income tax	$ 5,208	$ 6,027
Schedule SE		
Self-employment income	$ 38,659	$ 34,512
Self-employment tax	4,755	4,245
Total Federal taxes	$ 9,963	$ 10,272

cow sales (Form 4797). The farmer owes income taxes of $5,531 and self-employment taxes of $3,688, for a total tax liability of $9,219.

Under the Tax Reform Act, the farmer will pay $6,160 in Federal income taxes, or about 11 percent more than under current law. Self-employment tax liability will decrease slightly to $3,575. As a result, total Federal taxes paid will increase by $516.

Effects on a Hog Operation.—This farmer is the sole proprietor of a 1,600-head hog operation and produces corn for use on the farm and for sale. The farmer also grows soybeans for sale. Unpaid family labor is needed, limiting opportunities for off-farm income. The family takes personal exemptions for four and claims the standard deduction.

Under current law, the farmer earns $38,659 in net farm profits (Schedule F), and $9,508 in capital gains from culled sow sales (Form 4797). The family pays $5,208 in Federal income taxes and an additional $4,755 in self-employment taxes, for a total of $9,963.

Under the Tax Reform Act, Federal income taxes for the same farmer increase to $6,027. However, the producer pays a lower self-employment tax because net farm profit for tax purposes is lower.

The new law's most significant effects on this operator's tax obligations come from the elimination of the investment tax credit and capital gains treatment for culled sows. Elimination of capital gains treatment means that $9,508 in cull sales must be taxed as ordinary income. The farmer loses $2,320 in investment tax credits. However, depreciation deductions rise by approximately $4,147 because the producer can now immediately deduct capital expenditures of $10,000, rather than $5,000. Overall, the farmer's total Federal taxes increase by $309.

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